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TRENDS

An Analysis of Emerging Trends in the Securities Industry

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STRUCTURING FOR SUCCESS - TRENDS FOR THE 1990s

Highlights of SIA's 1990 Trends Conference
March 1, 1990, New York Hilton

HARRISON J. GOLDIN

Principal, Goldin Associates
Founder & Chairman Emeritus, Council of Institutional Investors
Former City Comptroller, New York City

"The Buy Side's View - Customer Demands for the 1990s"

Institutional investors in the 1990s will be emphasizing foreign investments, private placements, real estate opportunities, oil and gas production, opportunities targeted locally to promote affordable housing and small business, and companies with longer time horizons in their business strategies.

The most significant development today is the keen interest of institutional investors in foreign investment. Pension funds are raising their international targets from 10% to as much as 20% of their assets. That trend will not only gather strength in 1990, but remain strong throughout the Nineties.

Public pension funds are somewhat behind their private and foundation counterparts in exploiting international investment opportunities. But the decade will see a surge of public pension asset commitments to foreign stocks and bonds. The bulk of their foreign investments this year and next will be in indices that both spread risk and reduce the need to make selections among individual companies. Nonetheless, not all investments will be in developed countries. Some will be in emerging markets: Argentina, Brazil, Mexico, Taiwan, Thailand, South Korea to mention a few.

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A second category of investments likely to increase significantly is private placements. To an ever greater extent, institutional investors are being asked to buy stock or bond issues not traded publicly. More and more institutional investors are saying yes.

The institutional market for the third category, real estate, is soft at the moment. Pension funds generally are diffident about real estate but that will change. Patient and foresighted institutional investors will consider the weak market a good buying opportunity.

The situation is similar in oil and gas. Depressed prices, a heightened public sensitivity to the environment, and vocal opposition to localized drilling operations have all dampened exploration and production of oil and gas. But the real price of oil and gas is likely to rise in the 1990s while new technology and safeguards will make exploration, production, as well as transportation, environmentally safer. Institutional investors will invest in this opportunity.

A fifth emphasis is likely to be targeted investments. We pioneered this field when I was Comptroller of New York City and saw no problem using public pension funds to promote social objectives, especially affordable housing in NYC, so long as the pension systems received market rates of return on their investments. For instance, mortgages extended by our agents in red-lined and moderate income communities in NYC were pooled into federally guaranteed, high yield Ginnie Maes, $700 million of which were purchased by the city pension funds. That increased liquidity in neighborhoods in which lenders are typically reluctant to invest, providing additional funds for lower and moderate income housing and resulting in new and rehabilitated homes for thousands of New Yorkers.

Finally, institutional interest will likely grow in investments that require a longer time horizon. This is not venture capital for new businesses, but what is now called patient capital - for businesses that have not yet made it big but are at a critical point in their development. These are companies with successful operations that are deliberately plowing significant portions of their profits into research and development and other internal investments. The rationale is that smaller gains now could lead to a commensurately greater return in the future.

STEPHEN L. BROWN

President and Chief Operations Officer
John Hancock Mutual Life Insurance Co.

"Structuring an Integrated Financial Services Firm"

A diversification strategy makes good business sense because it improves the likelihood that some lines of business will be profitable when other lines have problems. The cliche about spreading one's eggs among a number of baskets is right. It's also important to move into businesses which build on a corporation's strength and image and put the company in the path of future growth. Of course, growth and profitability aren't necessarily the same.

It isn't enough just to enter new businesses; successful diversification also means significant changes in parent company strategy and culture. A diversification strategy has to be accompanied by some crucial supporting strategies. At Hancock, we clearly said that our strategy for the 1980s was to diversify into other financial services businesses, pursue a market oriented and profit-centered strategy, and pursue a financial strategy which enabled us to track and compare the performance of our insurance and non-insurance businesses on a timely and consistent basis.

The advantage of being able to compare performance within our financial services complex is that we can make objective decisions about which products and businesses should grow and which ones should diminish.

We defined our organization as having three major markets: retail, investments and pensions, and group. Within these, we refined each of those businesses into product and profit centers with managers accountable for each separate business. We developed a system to compare the performances of very different businesses. An internal system of GAAP accounting was developed, which we were not required to do as a mutual company. This enabled us to compare our overall performance with the new competitors that we faced.

With these tools in place and reporting systems greatly speeded up, we were able to measure current performance and future plans of each business segment against firm-wide goals for financial strength, growth and profitability, and to compare capital requests from each business and determine which offered the firm the most attractive long-term returns.

Recent history has shown that diversification can be very treacherous and involves changes that many companies are not prepared for. Clearly the S&Ls are the worst case, but I'm afraid many of us entered businesses whose pitfalls we didn't understand fully. Whether we survive those pitfalls depends greatly on the size of our investment and the extent to which we take steps to understand the risks of new businesses.

Invariably, we will make mistakes, especially as the business outlook changes. For example, we looked at the numbers on HMOs in 1983 with that business segment returning about 25% a year for as far as the eye could see. Five years later, returns were becoming marginal at best, and projections told us that the future was bleak for all but a few major competitors. We were faced with a choice to either make the very heavy investments required in such a marketplace or to exit the HMO business entirely and move our capital into areas with better returns.

Said this way, there really doesn't seem to be any question that exiting was best. For most of us, deciding to exit a going business is very difficult and a lot of emotion and ego gets involved. Without a structure and a financial discipline to enforce such decisions, the likelihood is that some of those difficult decisions won't be made or will be deferred until it's too late.

After 1987, we clearly had to re-evaluate our brokerage business and decide whether our initial strategy of building from a regional to a national presence still made sense. Tucker Anthony depends heavily on retail business and post-crash there wasn't an awful lot of retail business around. At the same time, we asked ourselves whether pursuit of a national brokerage identity was worth the costs involved or if regional firms with strong research and local identity and presence would offer a better return. We made a strategic shift starting about two years ago, and our brokerage business today is profitable and on the way to meeting its long-term profit goals. Equally important, it's developed a good balance of retail and other businesses.

Our decisions regarding HMOs and our brokerage arm were really quite different - in one case to exit the business, in the other to change strategy. Both resulted from the underlying structure we developed to help make those decisions. Hancock does not enter the 1990s with any guarantees, but I believe that we have given ourselves the best possible chance to succeed.

ROY C. SMITH

Professor of Finance, N.Y.U. Graduate School of Business
Former Partner, Goldman, Sachs & Co.

"Global Banking in the 1990s"

Europe — An economically integrated Europe will be the world's largest single marketplace for goods and services and will attract large amounts of strategic investments by European companies as well as from U.S. and Japanese companies who will move funds away from the U.S. and Japan. The European restructuring will become even larger if non-EEC European countries become members or if Eastern European countries are able to join in some manner.

There was more than $160 billion in mergers involving European corporations last year, half the world's total. The process is still in a very early stage, but it already involves most forms of free market transactions including hostile bids and leverage buyouts. While U.S. M&A has dried-up, European M&A is now the fastest growing sector in global M&A.

A large, single European capital market has begun to emerge. This new intra-European market will reflect the consolidation of previously separate domestic markets with a much more global Eurobond market. Already this single market has the capacity to do about $300 billion worth of long-term financing per year, which is about the same amount per dollar of GNP as we have in the United States.

Competition will greatly increase the efficiency of this capital market to borrowers, and many industrial companies will develop capital market access for the first time. In Europe, the practice has not been for industrial companies to use the capital markets to the same extent as in the U.S. This is changing. Also, European companies will no longer have to arrange their financing in Dollars or Yen, but rather in European currencies or in ECUs.

Competition for financial businesses in Europe will greatly intensify, just as after Big Bang. The traditional house bank relationships - one bank, one company - will have to meet the best prices offered to their clients or lose the business, a condition similar to the introduction of the bought deal in the Eurobond market in 1981 and the introduction of Rule 415 in the U.S. in 1982. Product adaptability, expertise, and marketing will be the key ingredients in competitive success and relationship banking in Europe will become more transactional.

The financial environment in Europe in the 1990s - driven by free competition from players from all over the world and fortified by large existing markets such as foreign exchange, swaps, futures and commodities - could become the world's most competitive source of capital, thereby attracting many of the world's largest and most important borrowers from the capital markets they presently use. The implications for U.S. companies is pretty clear: we can lose some of our corporate business to the European markets if we overlook this new competitive challenge.

Japan — Japanese financial markets are likely to experience substantial deregulation in the 1990s which could, in turn, lead to major changes in the competitive dominance of Japanese banks and brokers. The business of Japanese banks has changed radically in the last few years. Through all the period of excess liquidity in Japan, Japanese companies have paid off most of their debt. So, banks are looking for business other than corporate loans and they're focusing on the securities business. They're prevented from entering the securities business by their own Glass-Steagall: Article 65. But if Glass-Steagall is repealed in the U.S., Japan will likely follow suit. After that occurs, competition in the Japanese securities sector will also become very intense, i.e. the idea of fixed commission rates remaining in a post-Article 65 environment is almost unthinkable. As a result, you may see a Big Bang coming to Japan as well.

United States — The big events affecting our industry in the next few years will be Glass-Stegall and the restrictions on the interstate banking competition. Both represent large changes in the structure of the U.S. banking and investment banking industries, and it puts the banks in a dilemma. They have to decide which of these two sectors to move towards. A few can afford to do both, but not many.

The success of specialized investment firms like KKR may encourage some of the individuals at investment banks to go into smaller, more traditional, more profitable, more flexible businesses that reflect investment banking's earliest days. And we've already seen a proliferation of boutiques starting up.

Banks and investment banks will provide wide-scale global services. Also, this may mean convergence with large organizations already skilled in trading foreign exchange, government bonds and some municipal securities but who perhaps have a better management feel and a better ability to operate on a global basis. In the U.S., we'll also see an increasing role played by foreign firms — both banks and securities firms.

JAMES W. WETZLER

New York State Tax Commissioner

"New Frontier - Growing State & Local Tax Initiatives"

During the 1980s, New York State, along with much of the Northeast, was growing faster than the national economy, to some extent helped by the boom in financial services. When New York and the Northeast have an economic boom, it's different than when California, Florida or the Sun Belt has a boom, because these places attract a lot of people in prosperous times while people don't tend to move into the Northeast very often. Therefore, when our economy booms, people become more fully employed, wages go up, real estate prices go up, etc. That's great for those who already own the real estate or receive the higher wages, but it discourages new people and firms to come in and buy expensive real estate, set up shop, and pay higher wages. The effect of the past boom is to make the State and region less competitive now.

Also, the national savings rate has been going up the last couple of years which has the effect of lowering our sales tax receipts, a significant source of revenue. As a result of the Federal Tax Reform Act, a lot more corporations are using Subchapter S corporations, taxed essentially as partnerships, which has, in turn, reduced our business tax receipts. Also, many corporations are now making more money overseas than they are in the U.S., which is non-taxable in New York.

We've had big cutbacks in federal assistance to New York throughout the 1980s. President Bush speaks about doing something about drugs, about education, and whatever, but he means that the states should do it. He's creating popular expectations on these issues but is not giving states the resources to address them nor is he proposing that Washington take on some of that burden.

We have the rise of a new set of expensive problems, like AIDS and drugs, the solution to which will not improve the quality of life of an ordinary person - it will simply prevent it from getting worse. Addressing these problems may prevent a mugging or whatever, but a mugging that doesn't happen is not noticeable as an improvement to your life.

The net effect is that New York has a significant gap between expenditures and tax revenues. At the same time, New York is competing economically with other states and countries, and in order to prosper, we need to be an attractive place for people to live and do business in. For that to happen, the tax burden has to be in some balance with the level of public services that people see they're getting, and their quality of life.

The competitiveness issue is not just in attracting firms to come to New York, but keeping those here from moving out. We're cognizant of the mobility of the financial services business. New York discovered mobility in the 1970s with the big exodus of the manufacturing sector. As a result, the tax system was changed to favor manufacturing.

We're now beginning to realize that a similar problem exists for service businesses but policies have not yet adjusted to accommodate that perception. We have not been entirely inactive about this and have done some things including tax reforms for personal income, corporate franchises, banks, trucking, gasoline, diesel fuel, etc.

Nationally, a lot of things are happening in state and local taxation that are of interest to the securities industry. One issue is apportionment - technical tax considerations of how to apportion a multi-state or multi-national business's income to a particular state. Also, how much contact does a business have to have with a state in order for that state to be able to start taxing it? Typically, income from a service business is apportioned to the state where the services are performed. There is a movement afoot, however, to apportion income from a service business to the state where the customer is located. A number of states, typically the states that don't have financial services businesses, are beginning to adopt this approach - they basically want to raid our tax base. This is being promoted by the Multi-State Tax Commission, which is a compact of most of the western states.

Another area is sales taxes which currently apply mainly to goods. As the economy grows, services tend to grow larger as a percentage of people's spending. In a number of states, there's a trend towards extending sales tax to services. Another trend in many states is for more aggressive tax enforcement. You're going to be visited by more auditors from more states as they beef up tax enforcement efforts.

One serious problem in New York is that state tax is not the only tax you're dealing with. There is a New York City Corporate Tax, there is an MTA surcharge, the combined burden of which can be very, very high - up around 18.4%.

We want to help, but the problem is we have to understand things before we can help. The securities industry must come up and tell us — the Budget Division, the Legislature, the Governor, and the Tax Department — what your major concerns are.

RICHARD FURNISS

Vice President, Towers, Perrin, Forster & Crosby

"Changing Compensation Practices for the 1990s"

Wall Street is intensely dependent on individuals. The securities business requires people to do things by themselves which puts a great deal of emphasis on keeping key producers. There is a valid fear of losing them, stoked by the individual who can always produce a string of offers, many quite real.

Salaries are kept low, because we want to keep our fixed costs down, while the bulk of compensation is dependent on performance: no performance, no pay - a great concept. On Wall Street, firm profits were shared among the professionals. When firms were enormously profitable, often from a small number of businesses, everybody in the

professional ranks shared in the pie, often in extreme proportions to the total profit. This is very unusual in the world of compensation, a holdover of the partnership tradition, and does not serve the shareholders.

These incentive plans are paid out in two ways. One is highly discretionary - 100% judgment checks, with very vague measures of performance or goals, which arrive in mysterious ways but are large enough so that it doesn't bother anybody. Everybody who doesn't get paid this way is paid on a fixed, very rigid formula characterized by a sales commission, often with nothing to do with profit but driven by volume or revenue.

So you've got a tremendous component of cost driven by a very unsophisticated and almost unmanageable system - an unstable situation. It worked when firms were awash in money but things have changed and it looks like they've changed permanently. Compensation systems will also have to change.

Business segment profitability will no longer be cyclical, some will be permanently higher or lower. Therefore, no longer can everyone be compensated equally on the basis it will balance out over the years. You have now moved into capital intensive businesses which isn't purely brains, it's putting the firm's capital at risk. Revenue is much less relevant to profit and therefore compensation will have to be more relevant to the bottom line than the top line.

Producers continue to expect high rewards but profits are inadequate to pay both the bonuses and the shareholders. So far, the shareholders have suffered. If the shareholders are also the employees, then it doesn't matter. If the shareholders are the public or some firm that's acquired an investment bank, then you have an unstable situation.

Also, variable pay has become a fixed cost. Securities firms' financial statements show normal fixed costs — salary, rent, interest, etc. — but then you'll also see bonus accruals listed there whether or not there is a profit. Shareholders will say, wait a minute, how come you have bonus accruals when you've got a loss here? The rest of the world doesn't do it that way, they do bonuses after profits. That isn't how it works in Wall Street because you have to pay bonuses to keep people. If I were a shareholder, I'd say that's not the way you're going to do it in the future.

You do have to keep good people, however, so what will happen? Pay for performance - that's the secret. Pay for performance requires management decisions that are hard to make. It will require changes in the way you measure profit. It will require you to keep different sets of books. It'll require you to combine functions that haven't been combined before. It'll even require you to measure customer profitability. The notion of selling a customer something cheap because he's going to buy another product on which you make a great profit is a fallacy that's lead all kinds of companies into Chapter 11, because customers have gotten smart. They'll buy some products from you cheap and they'll buy the rest of their products from somebody else cheap.

So somewhere you've got to revise your system to pay people for generating profit, not revenue. Differentiation of pay is the only way to resolve the dilemma of losing good people. The truth of the matter is that only some people are good. And though these people will continue to move around, that doesn't mean that you've got to pay everybody. What it means is that you've got to pay the producers.

Senior level pay will be based on firm results. As someone moves up the hierarchy in a particular department or function, the less he'll be compensated for results of that function and the more he'll receive based on firm-wide results. There'll be more equity based plans and we've seen a rash of them this year driven by two reasons. One is the classic reason of spreading ownership among employees to make them feel and act like owners. The second reason is the cash isn't there to pay the bonuses that were expected, so stock was used instead.

JOANNE M. HILL

First Vice President, Capital Markets, PaineWebber Inc.

"Trading Technologies for the 1990s"

Technology combined with information and trading vehicles brings market power. Information in the investment business is power. Technology shifts the power balance in the financial marketplace because it allows greater quantities of information to be processed much faster.

Technology is not free and it has definite economies of scale. This means that larger players, who some say already have an advantage because of their size, can also gain advantage by tapping into information more easily and cheaply. Technology doesn't increase trading volume and liquidity, it just shortens the time span for prices to adjust to information. Only investors with easy access to information can expect to profit from being short-term investors.

Investors with more limited access are best served by approaching investments based on their ability to deliver long-term returns in line with their risk profiles. They become strategic asset allocators. It's really not surprising that institutions use asset allocation while, similarly, individual investors shifted to indirect equity vehicles like mutual funds which do this job for them.

Information and technology advantages in stocks or overall portfolios only exist if you have vehicles to capitalize on them. We've always had abilities to respond to stock information but if we have news of a trade deficit or a stronger dollar, without a vehicle to act on this news, is of little value for all U.S. stocks. Now comes index futures and portfolio trading which can apply this technology and act on macro information. These products are indeed the messengers and they've been receiving a lot of bullet holes.

Is it okay for a risk arbitrageur or a mutual fund holding a takeover stock to have tools to react very quickly when news hits the screen but wrong for a portfolio trader to have access to a SuperDOT terminal or a futures market when an economic number alters his asset allocation mix? Is it okay for a trader in stocks to use stop loss techniques that are monitored by some intelligent quote service but wrong for a dynamic hedger to sell stocks or futures when a trigger level is hit?

Currently there are $275 billion of U.S. institutional investments passively managed, of which about $200 billion are in equities - about 20% of all pension equity money. In addition, about 50% of U.S. money going abroad goes into an index fund, i.e. passive management. Passive management has become a dirty word in the securities business. It implies low turnover and low commission rates. But this is an important reason for pension funds, foundations and large investors to choose passive management for their beneficiaries.

To most of us, asset class or program trading is the most scary application of technology. These trades are less frequent than individual stock trades, and they use up a lot of liquidity. But it's very sensible for these people to go where they can find the lowest price which is more often a futures market, not a securities market. This is not because they're benefitting from lower margin requirements because these people are not users of leverage, ERISA limits leverage. It's because the index futures market has 20 times the depth of volume than the NYSE for these trades.

A fundamental or technical asset mixed trade can enter the system from either the futures, options or security markets. If it is large enough, it will be associated with volatility or price change in the same way that a large trade in IBM or Exxon is going to be associated with volatility or price change in that stock. If the trade occurs first in the futures market, this will transmit the impact of the change in the institution's equity exposure through the futures market into the equity market.

Using NYSE program trading data, academics and economists have looked at stock prices following program trades and have determined that these trades carry real information about stock values to the marketplace and not just "noise." If we did not have this type of trading, the information would be absorbed more slowly, through manual stock trades, than what now happens simultaneously through technology.

TIMOTHY F. MCCARTHY

Executive V.P., National Financial - Fidelity Investments

"Clearing Choices for the 1990s"

The October, 1987 earthquake is still sending shock waves through Wall Street. In 1989, four of the seven major clearing firms either went out of business or were substantially reduced in size and influence. Meanwhile, 15% of securities firm clients are no longer in

existence. The template for the clearing industry that many of us followed throughout the 1980s is broken and if we expect to succeed in the 1990s, radical adjustments in our attitude and structure are absolutely imperative.

The clearing vendor's role must expand dramatically to help the correspondent client compete. The real threat to our client's long-term success is not just the correspondent clearing firm competition but the local Merrill Lynch or Shearson office. If, for competitive reasons, the correspondent needs to give his investors a consolidated CMA-type statement or needs RR training and sophisticated product marketing support which the Shearson office manager is supplied with from headquarters, the clearing vendor better be ready to supply it so both you and your client can operate and compete.

In the 1990s, there is room for certain vendors to succeed by narrowing their focus, becoming specialists in one or more areas such as clearing asset-backed securities for institutions or executing only non-U.S. securities. However, the dominant clearing players will reach a critical mass in providing a whole raft of services. This integrated package of service will go far beyond what any one vendor today supplies its correspondents. I wouldn't be surprised if a major clearer finally merges with a quote vendor or another information or record-keeping provider. This kind of integration and coordination of services is being demanded of many vendors by their correspondents today.

To succeed, your entire organization must truly be systems literate. The connection between the systems organization and operations must become seemless — systems and operations people will often have had each other's job. Managers will be preoccupied with ripping apart every aspect of their operation and installing system solutions previously thought impossible to insure quick response to their clients' needs. Technological literacy will permeate not only operations and trading, but such areas as client services. The result: decreased labor cost and unparalleled quality.

It is clearly wishful thinking to expect clearing and execution fees to return to the fatter days of the past. Efficient systems are insuring that prices will not rise to any large degree. Surviving vendors will do a lot more product service cost accounting and profitability analysis to determine whether or not they're making money on each client and to get rid of those that are money losers. This better understanding of costs should lead to a lot more price unbundling: higher charges for manually intensive items such as non-book entry or infrequent, low volume trades.

High market volatility, new and expensive systems philosophies, the expanded role of the clearing vendor, and continued low margins all translate to much greater capital requirements for the clearing vendor. As a correspondent, your clearing vendor's capital reserves and a demonstrated commitment to the clearing business is absolutely critical to your competitiveness.

The cost of building a competitive capability will mean that the part-time clearing vendors will diminish in importance. It's very difficult to compete, even in one or two niches

in the brokerage business, without spending at least $25 to $30 million on a system. Most of the majors have spent well over $100 million. Right now, half the business is done by the top five clearers and the other half is spread over 340 different clearing vendors. By the end of the decade, the top five or six will control three-quarters of the business and only 100 others will make up the balance.

Still, the business of clearing other brokers' trades has increased. Around the time of the crash, less than 15% of commission revenues came from introducing firms but now that number is well over 20% and will grow to 33%. We in the clearing industry have a lot of growth opportunity if we redefine our roles and show the small self-clearers, through our actions, that we can help them compete more profitably.

HOWARD M. BRENNER

President, Drexel Burnham Lambert Inc.

"Restructuring - Downsizing"

The first thing to do when thinking about restructuring is to define your goals. These goals may be to reduce your fixed costs, increase your profitability, lower your break-even, to make yourself more efficient.

Secondly, you must determine who is going to be part of the team to evaluate this decision. When we looked at our retail business last January, we formed a team of eight senior people and an outside consultant which met once a week with the idea that by April 15 we would reach a conclusion. Next, you must determine how you're going to meet. We essentially met in secret because this was the type of exercise that you don't want rumors floating around.

Third, you've got to determine how to get your information, and sometimes that's very tricky. You've got to have the cooperation of your financial people and your financial analysts, but to a very large degree you do not want to go to the people who are actually involved in the operation because you will spook them. An outside consultant makes this job a little easier.

You have to determine what the effects of changing or exiting one business will be on other parts of your business. How integrally involved in your operation is OTC relative to institutional sales? How valuable is it for the retail and the retail mark-ups? For municipals, how important is it to have a retail distribution as opposed to municipal finance? If you have a corporate finance activity, how important is it to have a research effort and then a distribution capability on an institutional level, because on most underwritings today, 70% to 75% of them are done by the institutional area.

The next issue — are you the right size? When we looked at our operation, we had 1,100 people but heading south with the government investigation hanging over us. We felt

you had to have at least 1,900 to 2,000 AEs in order to economically supply the services that we were giving our people. And then you had to look at what was your comparable rate of return on your investment — how much money did you have in this and what were the advantages or disadvantages? Did you have any cost advantages? Could you do business cheaper? Did the fact that you were processing so many trades help in your operation? Did it help in the distribution of your underwritings that some clients wanted major distribution?

You had to determine your market share, what your growth was going to be, what were your strengths and how could you deal with them. Were you competitive? Could you continue to pay up-front dollars, forgivable loans and all of those other nice things to attract salesmen? And you had to recognize your weaknesses.

Based on that, we put together a model. We were doing about $340 million worth of business with 1,100 AE's and a production per AE over $300,000 per man. How many more AEs do you need to raise your rate of return, to raise your earnings? This said to us that we could not break even in that business until we had 1,900 AEs, and we could not get to 1,900 AEs until 1992, which meant that we had to look at red ink in 1989, 1990 and 1991.

Then there was a very major and tricky issue to deal with. We were charging retail about $72 million worth of allocated expenses which, if you closed retail down, you would have to lower costs by $72 million just to break even. Where do you now allocate research? How and where do you cut people and still remain as efficient? Computers do not go away. You've got this big massive IBM computer, you've paid for it, you're running it — the fixed costs of that are not going to go away. You probably have a network that goes around the country. Are you going to close your institutional branches or leave them open? Can you get the costs out of your network? If you have an international network, you can't lower many costs. You have your order matching systems that go to the floor of the New York Stock Exchange and various other exchanges. To a degree, they're not going to change.

Corporate overhead — is it going to go away? You have a major advertising campaign that you charge across a broad spectrum. Will you be able to continue to do that or not? In our case, we were able to cut $75 million out of overhead but we had a unique case where approximately 10% of our revenue came from retail but it was running at a loss. We lost 4,000 people in the restructuring and at the time, it looked like a very wise decision.

There are a lot of costs of getting out of a business and you've got to figure those costs in. A very major one is the the Plant Closing Act — which requires everybody who doesn't get a job as part of the transaction to be paid a minimum of eight and a half weeks severance. That is a large, large number. If you are involved in the retail business, you probably gave forgivable loans when you hired salesmen. How do you deal with that?

You have to deal with the asset side of the ledger. Are you going to be able to sell all the offices? Can you get somebody to take them all on? Then you deal with the outside forces. Is it going to be perceived that you're going from being a major full service firm to being a boutique or an institutional firm.

A very major issue that came up with us was the capital issue. We were an employee-owned corporation with only one large outside institutional holder. When we did this transaction there was a loss of equity capital of over $200 million. That was to a degree free money and then suddenly 30% was immediately gone and the other 70% went into subordinated debt which you now had to pay 11% or 12% on. That has to be factored in.

Public relations — how you deal with it with the public, with your remaining clientele base and with your own employees? Is this the start of a major downsizing? Is this going to be part of a larger restructuring? The rumors that will float through an organization during these periods get very hot and heavy. So it does create a morale problem for the total organization.

Downsizing is a complex issue. You have to keep it quiet, you've got to think it through carefully and thoughtfuily. Finally, when you do decide to move, you should move very rapidly so as to not lose control of the process.

VOLUME

	FEB. 1990	YTD 1990	FEB. 1989	YTD 1989	% CHG YTD 1990-1989
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	155.9	164.2	169.3	168.8	-2.7%
AMEX (MILS.)*	13.7	14.2	11.8	11.3	26.2%
NASDAQ (MILS.)*	127.5	132.6	133.2	131.3	1.0%
REGIONAL EXCHANGE (MILS.)*	25.0	26.5	27.5	27.0	-1.9%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$99,458	$233,980	$111,971	$236,208	-0.9%
AMEX (MILS.)	2,978	6,769	2,951	5,428	24.7%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	7,846	19,282	8,876	17,447	10.5%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	12,326	29,517	15,401	33,436	-11.7%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	51.1%	49.3%	51.9%	52.5%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	9,764	22,194	10,875	21,881	1.4%
AMEX OPTIONS	2,798	6,553	3,142	6,565	-0.2%
COMMODITY	22,724	47,894	21,691	42,9[illegible]	11.4%

PRICES
(END OF MONTH)

	FEB. 1990	FEB. 1989	% CHG FEB. 1990-1989
DOW JONES INDUSTRIALS	2627.25	2258.39	16.33%
STANDARD & POOR'S 500	331.89	288.86	14.90%
NYSE COMPOSITE	183.07	162.49	12.67%
AMEX MARKET VALUE INDEX	352.90	322.47	9.44%
VALUE LINE COMPOSITE	239.68	242.95	-1.35%
NASDAQ COMPOSITE	425.83	399.71	6.53%

YIELDS
(MONTHLY AVERAGES)

	FEB. 1990	FEB. 1989	% CHG FEB. 1990-1989
BOND BUYER INDEX (20 BOND)	7.22%	7.44%	(22)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.22	9.64	(42)
Baa CORPORATE	10.14	10.61	(47)
RATIO Aaa CORPS. TO Baa CORPS.	0.91	0.91	0

UNDERWRITING

	FIRST QUARTER 1990	FIRST QUARTER 1989	% CHANGE 1990-1989
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$78,918.2	$72,373.0	9.0%
Common Stock	$7,125.6	$3,899.5	82.7%
# of Common Stock Issues	114	68	67.6%
Preferred Stock	$1,314.8	$559.3	135.1%
# of Preferred Stock Issues	23	13	76.9%
Corporate Debt	$70,477.8	$67,914.2	3.8%
# of Corporate Debt Issues	1275	850	50.0%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$15,538.1	$18,134.9	-14.3%
# of Issues	661	967	-31.6%
Competitive	$7,825.1	$6,558.2	19.3%
# of Issues	774	772	0.3%

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
SOURCES - - The Securities Executive's Guide to Products & Services 1990-1991	Easy-to-use buyer's guide to products and services directly related to the securities industry. Directory listings of firms provide a brief description of company's specialization, along with address, phone and contact person.	SIA Publications Department Price: $5.00
"Little Action in the First Quarter"	First-quarter underwriting rankings. Merrill clings to overall lead as first quarter sees dramatic new mix of securities. Strong gains in mortgage- and asset-backed securities make up for drops in investment grade and junk debt, but just barely. Investment grade offerings dropped 22.2% compared to 1989's first quarter, from $32.9 billion to $25.9 billion. Industrial corporations, concerned over the direction of rates, either turned to their commercial paper programs or simply waited for the rate picture to come into focus.	Investment Dealers' Digest, April 9
"Do Margin Requirements Matter? Evidence from U.S. and Japanese Stock Markets"	In considering whether margin requirements are an effective policy tool in curbing volatility, this article reviews evidence on the relationship between margin rules and volatility in the U.S. and offers new evidence drawn from the Japanese experience with margin requirements. Given that margin requirements have changed only 22 times in the U.S. in the last 55 years, the authors turned to the Japanese market where margin requirements have changed over 100 times in the past 35 years. Using the Japanese data for analysis, the authors concluded that margin requirements are quite effective in curbing gyrations in stock prices.	Federal Reserve Bank of New York Quarterly Review Winter 1989-90
NYSE Fact Book	Statistical "portrait" of the exchange community and market activity in 1989, with extensive historical data.	NYSE Publications Department

Item	Description	Source
Emerging Stock Markets Fact Book 1990	Reference source containing various time series of fundamental market data on more than 30 stock markets of the developing world. Fact book divided into 6 sections, which include an overview of emerging markets, stock market indexes, and a directory of stock exchange operations listing the addresses and principal officers of the major stock exchanges.	International Finance Corporation, 1818 H Street, Washington, D.C. 20433
"Implication of Introducing U.S. Withholding Taxes on Foreigners' Interest Income"	Study concludes that introduction of a 30% U.S. withholding tax on foreigners' interest income would make the U.S. better off if foreign governments do not retaliate. The trade balance would be improved only in the short run and exacerbated in the long run. If foreign governments retaliate the global efficiency losses associated with the new U.S. tax are enlarged. In terms of discouraging capital flight to the U.S. and related tax evasion, the author concludes there are other policies with less serious efficiency costs that might be equally effective.	Tax Policy and the Economy National Bureau of Economic Research, MIT Press Cambridge, MA 02142
Clearance and Settlement Reform -- The Stock, Options and Futures Markets Are Still at Risk	This report evaluates the sufficiency of industry and federal regulator actions in response to clearance and settlement recommendations made by the President's Working Group after the October 1987 crash. To examine the stock, stock options, and stock futures with respect to clearance and settlement, the study reviews federal, clearing organization, and exchange documents, including reports and regulations. Concludes: Certain clearance and settlement problems that occurred during the crash have been solved, but others remain uncorrected. The greatest progress has been made in upgrading trade processing systems.	U.S. General Accounting Office P.O. Box 6015 Gaithersburg, MD 20877